



TESTIMONY OF EDWARD FERRIGNO

THE DROP IN RETIREMENT SAVINGS: THE CHALLENGES SMALL BUSINESSES FACE FUNDING AND MAINTAINING RETIREMENT PLANS IN A STRUGGLING ECONOMY

HOUSE COMMITTEE ON SMALL BUSINESS

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Thank you, Chairwoman Velázquez, Ranking Member Graves, and members of the Committee for the opportunity to appear before you today to discuss the impact of the economic crisis on small business retirement plans. The Profit Sharing / 401k Council of America (PSCA) is a national non-profit association of 1,200 companies and their six million employees that advocates increased retirement security through profit sharing, 401(k), and related defined contribution programs to federal policymakers. It makes practical assistance available to its members on profit sharing and 401(k) plan design, administration, investment, compliance, and communication issues. Established in 1947, PSCA is based on the principle that defined contribution partnership in the workplace fits today's reality. PSCA's services are tailored to meet the needs of both large and small companies, with members ranging in size from Fortune 100 firms to small entrepreneurial businesses.

SMALL BUSINESS PLANS SHARE MANY ISSUES WITH LARGE PLANS. FIRST AND FOREMOST, THE MARKET CRISIS MUST BE ADDRESSED

401(k) plan participants, working in partnership with employers, can successfully manage normal market risks and cycles and accumulate ample assets for retirement. However, they cannot succeed without efficient and transparent capital markets.

The drop in 401(k) account balances in 2008 was not caused by a defect in the 401(k) system or by ignorant participants. These plans are caught in the same financial crisis that has paralyzed business and financial organizations throughout the world. 401(k) participants have suffered along with everyone else. Inadequate enforcement, misguided policy, reckless conduct, and unethical behavior in the capital markets are the problem, not 401(k) plans. We urge the Committee, and Congress, to direct their efforts

to ensuring that a similar market collapse never again occurs. 401(k) participants, as well as all other investors, will then be able to move confidently forward, knowing that saving and investing for the long term will pay off as expected.

The Department of Labor reports that in 2006, the latest year available, participants and employers contributed over \$250 billion to 401(k) type plans. The plans continue to improve, benefitting from a regulatory structure that permits flexible plan design and innovation. Automatic enrollment and target date funds were rare five years ago, but they are quickly becoming dominant plan design features. PSCA urges Congress to fix the markets and continue to work together with plan sponsors and providers to continually improve the very successful 401(k) system

Contrary to several published reports, real current data indicates that 401(k) participants are remaining resolute. They are not stopping contributions or increasing their loan activity. Hardship withdrawals have increased slightly, but the percentage of participants taking a hardship distribution remains well below two percent¹.

SMALL BUSINESS PLANS ARE NOT MONOLITHIC

The Small Business Administration classifies a small business as one with 500 employees or less. For purposes of retirement plans, there is a wide variance in the characteristics and concerns within this group.

In 2008, sixty-one percent of private sector workers had access to a retirement plan at work and fifty-one percent participated. Seventy-one percent of full-time workers had access and sixty percent participated.

Seventy-nine percent of all workers in establishments employing 100 or more workers had access to a retirement plan and sixty-seven percent participated. However, only forty-five percent of workers in establishments of less than 100 workers had access to a plan and thirty-seven percent participated. For establishments with between 50 and 100 workers, fifty-eight percent had access and forty-five percent participated. In businesses with less than fifty workers, forty-one percent had access and thirty-four percent participated². These participation rates are at a single point in time. They are not indicative of whether or not a non-participant or their household will choose to participate in a 401(k) plan for a substantial period of a working career.

The participation rate when offered a plan is encouraging, but can be improved. There are two areas in which to concentrate our efforts - lower-paid workers and small business plan coverage. We also need to increase participation by African-Americans and some ethnic groups, as revealed by some recent studies.

These statistics mean little if a worker is not saving for retirement. *One fact is abundantly clear – whether a worker saves for retirement is overwhelmingly determined by whether or not a worker is offered a retirement plan at work.*

Small business owners need simplicity and meaningful benefits for themselves to compensate for the costs of providing a plan to their workers.

The cost –benefit analysis for micro plans changes in an economic downturn.

¹ *Fidelity Reports on 2008 Trends in 401(k) Plans*, Fidelity Investments, January 28, 2009, and *Update on Participant Activity Amid Market Volatility*, Vanguard Center for Retirement Research, February 19, 2009.

² *Employee Benefits in the United States, March 2008*, Bureau of Labor Statistics, August 7, 2008.

In a very small business, the owner's personal financial situation is a major factor in deciding to offer a plan to employees. In exchange for the benefit of personally saving in a plan, the owner must be willing to absorb the expenses of offering a retirement plan to employees. The equation changes in an economic downturn. First, the personal benefit of a tax deferral for retirement contributions is reduced as the owner's tax rate is diminished by the reduced profitability of the business. On the other end, plan service providers might increase plan fees paid by the owner because plan assets are lower and participant activity resulting from market collapse is increasing. The owner may reconsider the advantages of offering a plan and merely contribute to an IRA. Another option is a low cost variable annuity, with no contribution limits, in which investment earnings are deferred the same as in a qualified plan. Variable annuities with no protection of principal are available for twenty-five basis points. If the owner has no current tax liability, this option is probably significantly more attractive than offering a plan.

SMALL BUSINESS ISSUES

The top-heavy rules should be repealed.

Many small companies have uncertain cash flows, and a required contribution to a retirement program could jeopardize a company's survival. Unfortunately, ERISA requires that most small companies do just that. An economic downturn, if accompanied by lay-offs, will exacerbate the problem.

The rules for employer-sponsored defined contribution plans may look the same for large and small companies, but, in practice, the results are very different. Large companies can exclude some employees from their plans and limit company contributions to those who make voluntary contributions or even make no company contribution at all. In contrast, small companies that are top heavy must contribute three percent of pay for every full-time employee over the age of twenty-one with one year of service.

This outcome stems from the top-heavy rules, one of the many government-imposed limitations and rules designed to ensure that company managers do not disproportionately benefit from 401(k) plan participation. Specifically, the top-heavy rules provide that if sixty percent of a plan's assets are in the accounts of highly compensated or key employee participants (HCEs), then the company must make a three percent contribution to all eligible employees. In addition, the top-heavy rules are among the most complex regulations in ERISA. For example, the top-heavy test is more complex than the 401(k) anti-discrimination test. In addition, the definition of those considered to be in the top paid group is broad and includes more employees, which makes the test more onerous.

In practice, nearly all companies with fewer than fifty employees will eventually fail the top-heavy test, even if they are not top-heavy initially. For companies with fewer than twenty-five employees, it is a virtual certainty. This is because small companies are owner-managed, so there is virtually no turnover in the company's HCEs. In contrast, turnover within the rest of a small company's workforce is usually very high – typically higher than turnover among similar employees at large companies. Large companies where the ratio of HCEs to non-highly compensated employees (NHCEs) is large are in no danger of failing the top-heavy test and can thus take advantage of all of the plan design flexibilities provided in the rules governing qualified retirement plans.

If a plan is top-heavy and does not comply with the required remedies, there are severe penalties: immediate disqualification of the plan, serious tax fines, and the possibility that the company may be liable for substantial make-up contributions and legal fees. For small businesses, the resources to cover

these fines and reparations – especially those with 50 or fewer employees – may put the entire company at risk.

Reform proposals should consider small plans

As Congress considers fee disclosure and other reforms, it is critical that a “lowest common denominator” approach be used. Small businesses do not have nearly the resources of a large business to meet their duties under ERISA. Legislators must keep this in mind when considering new provisions. For example, small businesses rely on service providers to tell them about plan fees. However, under ERISA, they have the responsibility to ensure that plan fees are reasonable, not the service provider. PSCA supports legislation that shifts the burden from plan sponsors to try to determine plan fees to service providers who will be required to furnish this information.

Many small businesses prefer reviewing costs in an aggregate or “bundled” manner. As long as they are fully informed of the services being provided, they can compare and evaluate whether the overall fees are reasonable without being required to analyze each fee on an itemized basis. For example, if a person buys a car, they don’t need to know the price of the engine if it were sold separately. They do need to know the horsepower and warranty. Any final legislation should preserve this option.

Mandatory payroll IRAs may result in significant costs

In the 110th Congress, HR 2176 was introduced by Representative Richard Neal. The bill creates mandatory payroll IRAs in which a business of ten or more employees that does not offer a retirement plan must offer a payroll IRA to employees. Employees age eighteen or older must be automatically enrolled at three percent of compensation. A small credit is intended to offset employer costs, which are portrayed to be minimal. President Obama supported this proposal during his candidacy and it will likely be included in his budget.

Because a default investment is required, the plans are subject to ERISA under HR 2167. The default investment must be prudently selected and fees must be reasonable. This duty normally entails significant cost, time, and liability exposure to plan sponsors. HR 2167 includes a TSP-type board to manage investments, but this provision is controversial.

PSCA is concerned about any mandatory benefit program. Additionally, the potential for significant costs for small businesses, when they can least afford them, has to be carefully considered when the proposal is reintroduced in the 111th Congress.

401(k) FEES IN THE ERISA FRAMEWORK

Numerous aspects of ERISA (the Employee Retirement Income Security Act of 1974) safeguard participants’ interests and 401(k) assets. Plan assets must generally be held in a trust that is separate from the employer’s assets. The fiduciary of the trust (normally the employer or committee within the employer) must operate the trust for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan. In other words, the fiduciary has a duty under ERISA to ensure that any expenses of operating the plan, to the extent they are paid with plan assets, are reasonable.

To comply with ERISA, plan administrators must ensure that the price of services is reasonable at the time the plan contracts for the services and over time. For example, asset-based fees should be monitored as plan assets grow to ensure that fee levels continue to be reasonable for services with relatively fixed

costs such as plan administration and per-participant recordkeeping. The plan administrator should be fully informed of all the services included in a bundled arrangement to make this assessment.

It is important to understand the realities of fees in 401(k) plans. There are significant recordkeeping, administrative, and compliance costs related to an employer provided plan that do not exist for individual retail investors. Nevertheless, because of economies of scale and the fiduciary's role in selecting investments and monitoring fees, the vast majority of participants in ERISA plans have access to capital markets at *lower cost* through their plans than the participants could obtain in the retail markets.

The Investment Company Institute reports that the average overall investment fee for stock mutual funds is 1.5% and that 401(k) investors pay half that amount.³ The level of fees paid among all ERISA plan participants will vary considerably, however, based on variables that include plan size (in dollars invested and/or number of participants), average participant account balances, asset mix, and the types of investments and the level of services being provided. Larger, older plans typically experience the lowest cost. Employer provided plans are often the only avenue of mutual fund investment available to lower-paid individuals who have great difficulty accumulating the minimum amounts necessary to begin investing in a mutual fund or to make subsequent investments. Finally, to the degree an employer provides a matching contribution, and most plans do, the plan participant is receiving an extraordinarily high rate of return on their investment that a retail product does not provide.

A study by CEM Benchmarking Inc. of 88 US defined contribution plans with total assets of \$512 billion (ranging from \$4 million to over \$10 billion per plan) and 8.3 million participants (ranging from fewer than 1,000 to over 100,000 per plan) found that total costs ranged from 6 to 154 basis points (bps) or 0.06 to 1.54 percent of plan assets in 2005. Total costs varied with overall plan size. Plans with assets in excess of \$10 billion averaged 28 bps while plans between \$0.5 billion and \$2.0 billion averaged 52 bps. In a separate analysis conducted for PSCA, CEM reported that, in 2005, its private sector corporate plans had total average costs of 33.4 bps and median costs of 29.8 bps.

Other surveys have found similar costs. HR Investment Consultants is a consulting firm providing a wide range of services to employers offering participant-directed retirement plans. It publishes the 401(k) Averages Book that contains plan fee benchmarking data. The 2008 Ninth Edition of the book reveals that average total plan costs ranged from 161 bps for plans with 25 participants to 96 bps for plans with 5,000 participants. The Committee on the Investment of Employee Benefit Assets (CEIBA), whose more than 120 members manage \$1.5 trillion in defined benefit and defined contribution plan assets on behalf of 16 million (defined benefit and defined contribution) plan participants and beneficiaries, found in a 2005 survey of members that plan costs paid by defined contribution plan participants averaged 29 bps.

PRINCIPLES OF REFORM

PSCA supports effective and efficient disclosure efforts. The following principles should be embodied in any effort to enhance fee disclosure in employer-provided retirement plans.

- **Sponsors and Participants' Information Needs Are Markedly Different.** Any new disclosure regime must recognize that plan sponsors (employers) and plan participants (employees) have markedly different disclosure needs.

³ *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses*, 2006, Investment Company Institute, September 2007.

- **Overloading Participants with Unduly Detailed Information Can Be Counterproductive.** Overly detailed and voluminous information may impair rather than enhance a participant's decision-making.
- **New Disclosure Requirements Will Carry Costs for Participants and So Must Be Fully Justified.** Participants will likely bear the costs of any new disclosure requirements so such new requirements must be justified in terms of providing a material benefit to plan participants' participation and investment decisions.
- **New Disclosure Requirements Should Not Require the Disclosure of Component Costs That Are Costly to Determine, Largely Arbitrary, and Unnecessary to Determine Overall Fee Reasonableness.** Bundled service providers should disclose the included services in detail. However, a requirement to "unbundle" bundled services and provide individual costs in many detailed categories would be arbitrary, is not particularly helpful, and would lead to information that is not meaningful. It also raises significant concerns as to how a service provider would disclose component costs for services if they were not offered outside a bundled contract. These costs will ultimately be passed on to plan participants through higher administrative fees. The increased burden for small businesses could inhibit new plan growth.
- **Information About Fees Must Be Provided Along with Other Information Participants Need to Make Sound Investment Decisions.** Participants need to know about fees and other costs associated with investing in the plan, but not in isolation. Fee information should appear in context with other key facts that participants should consider in making sound investment decisions. These facts include each plan investment option's historical performance, relative risks, investment objectives, and the identity of its adviser or manager.
- **Disclosure Should Facilitate Comparison But Sponsors Need Flexibility Regarding Format.** Disclosure should facilitate comparison among investment options, although employers should retain flexibility as to the appropriate format for workers.
- **Participants Should Receive Information at Enrollment and Have Ongoing Access.** Participants should receive fee and other key investment option information at enrollment and be informed periodically about fees.

HR 3185

PSCA supports legislation that will effectively improve fee transparency for sponsors and participants. HR 3185, as reported by the Committee on Education and Labor on April 16, 2008, reflects many of our principles and is a significant improvement over the original legislation. In addition to numerous minor adjustments to ensure that HR 3185 reflects the complexity of the retirement plan system, PSCA recommends three key changes. First, the legislation needs to include a "matching proposal" that specifies that the fiduciary duty to determine that fees are reasonable is limited in scope to the fees required to be disclosed under the legislation. The Committee agreed to examine this issue when Representative Kline offered and withdrew an implementing amendment during the 2008 mark-up. Second, Congress should abandon the "unbundling" requirement in the bill and permit both models to compete in the marketplace. Bundled providers should provide a detailed description of the services they

offer so that plan fiduciaries can determine that the aggregate fee is reasonable. Finally, the index fund requirement in the revised bill remains problematic.

DEFINED CONTRIBUTION PLANS WORK FOR EMPLOYEES, EMPLOYERS, AND AMERICA

Employers offer either a defined benefit or defined contribution, and sometimes both types, of retirement plan to their workers, depending on their own business needs. There are questions about the ability of the defined contribution system to produce adequate savings as it becomes the dominant form of employer provided retirement plan.

While some workers have enjoyed a full working career under a defined contribution plan such as a profit sharing plan, 401(k)-type plans in which the employee decides how much to save have existed for only slightly over twenty years, and most participants have participated in them for a much shorter period of time. The typical participant in 2000 had only participated in the plan for a little over seven years.⁴ Policymakers must be wary of statistics citing average 401(k) balances and balances of those approaching retirement because they have not saved over their full working career and some balances belong to brand new participants. For example, a recent Investment Company Institute report stated that at the end of 2006, the average 401(k) balance was \$61,346 and the median balance was \$18,986.⁵ The median age of the participants in the study was 44 and the median tenure in their current 401(k) plan was eight years. But when the study looked at individuals who were active participants in a 401(k) plan from 1999 to 2006 (including one of the worst bear markets since the Depression) the average 401(k) balance at the end of 2006 was \$121,202 and the median balance was \$66,650. Long-tenured (30 years with the same employer) individuals in their sixties who participated in a 401(k) plan during the 1999-2006 period had an average account balance of \$193,701 at the end of 2006. The study does not reflect that many individuals and households have multiple 401(k)-type accounts or assets rolled over into an IRA.

In their April 2007 paper, *The Rise of 401(k) Plans, Lifetime Earnings, and Wealth at Retirement*, James Poterba, Steven Venti, and David A. Wise reported the following:

“Our projections suggest that the average (over all persons) present value of real DB benefits at age 65 achieved a maximum in 2003, when this value was \$72,637 (in year 2000 dollars), and then began to decline. The projections also suggest that by 2010 the average level of 401(k) assets at age 65 will exceed the average present value of DB benefits at age 65. Thereafter the value of 401(k) assets grows rapidly, attaining levels much greater than the historical maximum present value of DB benefits. If equity returns between 2006 and 2040 are comparable to those observed historically, by 2040 average projected 401(k) assets of all persons age 65 will be over six times larger than the maximum level of DB benefits for a 65 year old achieved in 2003 (in year 2000 dollars).

Even if equity returns average 300 basis points below their historical value, we project that average 401(k) assets in 2040 would be 3.7 times as large as the value of DB benefits in 2003. These analyses consider changes in the aggregate level of pension assets. Although the projections indicate that the average level of retirement assets will grow very substantially over the next three or four decades,

⁴ *Rise of 401(k) Plans, Lifetime Earnings and Wealth at Retirement*, James Poterba, Steven F. Venti, and David A. Wise, NBER Working Paper 13091, May 2007.

⁵ *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2006*, Investment Company Institute, August 2007.

it is also clear that the accumulation of assets in 401(k)-like plans will vary across households. Whether a person has a 401(k) plan is strongly related to income. Low-income employees are much less likely than higher-income employees to be covered by a 401(k) or similar type of tax-deferred personal account plan.”

The Congressional Research Service estimates that a married household that contributes ten percent of earnings to a retirement plan for 30 years will be able to replace fifty-three percent of pre-retirement income. If they save for forty years, they will replace ninety-two percent of income.⁶ A ten percent savings rate is realistic given average contribution rates of seven percent and average employer contributions of three percent. These estimates do not consider Social Security payments

The growth of automatic enrollment plans will substantially increase retirement plan participation by lower and middle-income workers that are most likely to be induced to save by this type of plan design. Ninety percent of workers that are automatically enrolled choose not to opt out of the plan.⁷ A 2005 ICI/EBRI study projects that a lowest quartile worker reaching age 65 between 2030 and 2039 who participates in an automatic enrollment program with a 6% salary deferral (with no regard for an employer match) and investment in a life-cycle fund will have 401(k) assets adequate for 52% income replacement at retirement, not including social security that provides another 52% income replacement under today’s structure.⁸

The lesson is clear – long-term participation in a 401(k) plan will result in the accumulation of assets adequate to provide a secure retirement.

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⁶ *Retirement Savings: How Much Will Workers Have When They Retire?*, CRS Report For Congress, January 29, 2007.

⁷ *Hewitt Study Reveals Impact of Automatic Enrollment on Employees’ Retirement Savings Habits*, Hewitt Associates, October 25, 2006.

⁸ *The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement*, EBRI Issue Brief no. 238, July 2005.